PART I

EXEMPT ORGANIZATIONS TECHNICAL TOPICS

A. WHOLE HOSPITAL JOINT VENTURES

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1. Introduction

At first, joint venture arrangements between federally tax exempt hospitals and for-profit interests typically involved owning and operating ancillary health care services, such as an ambulatory surgery center or magnetic resonance imaging (MRI) facility. However, as tax exempt hospital systems sought to contain costs and compete for managed care contracts, whole hospital joint ventures between exempt hospitals and for-profit hospital corporations, also known as "disposition-type" joint ventures, have developed. A whole hospital joint venture involves a transaction in which the entire exempt activity, that is, the hospital's facilities and its services are transferred to the joint venture to then be operated by the joint venture rather than by the exempt entity.

There has been some case law regarding joint ventures between for-profit entities and exempt organizations. However, in the health care area, there has been neither case law nor, until recently, other guidance. Our pronouncements about known partnership transactions have not analyzed the whole hospital joint venture.

Thus, in response to the rapid increase and magnitude of nonprofit, exempt hospitals entering into joint venture arrangements with for-profit entities, in particular, the whole hospital joint venture arrangement, the Service recently released Rev. Rul. 98-15, 1998-12 I.R.B. 6, which provides guidance on the tax consequences of participation by IRC 501(c)(3) hospitals in joint ventures with for-profit entities.

This article addresses the different types and structures of joint ventures that have evolved. It revisits court cases involving partnerships and reviews the Service's reaction to various partnership arrangements. It discusses the issuance of Rev. Rul. 98-15; as well as current litigation. Finally, the article analyzes how such arrangements may affect an exempt hospital's tax exempt status and its foundation classification, or result in unrelated business income tax to the organization.

2. Background

Prior to Plumstead Theatre Society v. Commissioner, infra, the Service viewed participation in a joint venture with a for-profit entity by an IRC 501(c)(3) organization to be contrary to its requirement to act exclusively in furtherance of its exempt charitable purposes. GCM 36293 (May 30, 1975) concluded that an exempt organization's fiduciary obligations as a general partner in a limited partnership to promote the interests of the limited partners is inherently incompatible with IRC 501(c)(3) requirements. The GCM posited that the obligations placed on a general partner in these types of arrangements furthered the profit motives of the for-profit partners.

However, the Plumstead decision changed the joint venture analysis for exempt organizations. In Plumstead Theatre Society v. Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982), a nonprofit corporation formed to promote public interest in the theater encountered financial difficulties in raising its share of the costs in funding and producing a play that would run at the Kennedy Center in Washington. In order to meet its funding obligations, the organization entered into a limited partnership in which it served as general partner and two individuals and a for-profit corporation were the limited partners. The parties intended to share in both the profits and losses from the venture. The Tax Court concluded that the nonprofit's partnership obligations did not conflict with its tax-exempt status because: (1) the nonprofit did not have an obligation to return limited partners' capital contributions from its own funds; (2) the limited partners did not have control over the nonprofit's activities; and (3) none of the limited partners had any involvement in the nonprofit. The Ninth Circuit affirmed the Tax Court's decision.

Following the Plumstead decision, GCM 39005 (June 28, 1983), posited that an exempt organization may participate as a general partner in a limited partnership with a for-profit entity without per se resulting in denial of IRC 501(c)(3) status. GCM 39005 cautioned, however, that the partnership arrangement should be closely scrutinized to ensure that the exempt organization's participation in the joint venture allows it to operate exclusively for exempt purposes.

GCM 39005 applied a two-part standard for analyzing whether an exempt organization's participation as a general partner in a joint venture with a for-profit entity affects its exemption. The first part of the test is whether the organization's participation in the joint venture serves its exempt purposes. The second part of the test is whether the partnership arrangement permits the organization to act exclusively in furtherance of exempt purposes and does not result in more than incidental private benefit to the for-profit partners.

In a later case, Housing Pioneers v. Commissioner, T.C. Memo 1993-20, 65 T.C.M. 2191, aff'd, 49 F.3d 1395 (9th Cir.), amended, 58 F. 3d 401 (9th Cir. 1995) the Tax Court concluded that the organization's activities performed as co-general partner in limited

partnerships substantially furthered non-exempt purposes. It further held that private interests were served by its activities. The organization entered into partnerships as a one percent co-general partner of existing limited partnerships for the purpose of splitting the tax benefits with the for-profit partners. Under the management agreement, the organization's authority as co-general partner was narrowly circumscribed. The organization had no management responsibilities and could describe only a vague charitable function of surveying tenant needs. In affirming the Tax Court's decision, the Ninth Circuit noted, in the context of qualifications under IRC 42, that the organization failed to show that it had regular, continuous, or substantial activity in developing or operating the projects. The court further noted that the organization had failed to show that it was not affiliated with or controlled by a for-profit organization.

3. The Emergence of the Whole Hospital Joint Venture Arrangement

Through the years, exempt hospital systems have advanced numerous reasons for entering into joint ventures with for-profit entities, including, among others: impact of managed care; increased working capital needs; increased efficiency and cost savings; reduced financial risk; providing new, or ensuring continued, health care services in a community; and expansion of range and quality of services available to a community.

Whole hospital joint ventures gained a foothold when exempt hospital systems found a need to control their revenue base, expand patient coverage, and compete for managed care and physician organization contracts due to major health care alliances forming among providers. For the exempt hospital, the venture can provide some of the advantages of being associated with a large national company through greater bargaining potential with vendors and suppliers and access to potentially larger managed care contracts. Many exempt hospitals argue that not only will such ventures help them to provide care more efficiently for their communities by having services available at a lower cost by cutting out waste and duplication, but will also ensure that the hospital will survive in the competitive hospital market. There is tremendous pressure on hospitals to form networks. The exempt hospital can reduce its investment in health care operations or own a smaller part of a larger, diversified and stable operation. Finally, unlike a sale of assets, in a joint venture arrangement the exempt hospital would have a continued financial stake in and some involvement with the strategic direction of the hospital and its operations.

For-profit hospitals and hospital management corporations have been enthusiastic promoters of the whole hospital joint venture arrangement. They have represented it as a means for exempt hospitals to survive in a changing and competitive health care environment. It allows a for-profit hospital system to achieve control over a larger network of hospitals with a smaller investment. A for-profit entity that prefers not to expend resources for an outright purchase of the exempt hospital can acquire an interest in that hospital. The for-profit investor can make a cash contribution to the venture of half the value of the hospital, yet

exercise control over the hospital through a board of directors and a management agreement and be able to include all the gross revenues of the hospital in its consolidated financial statement. If the for-profit company has a hospital with a value at least equivalent to the nonprofit hospital in the area, the for-profit company, by giving the exempt hospital an equity interest in its existing facility in exchange for an interest in the exempt hospital, can double its gross revenues without any cash investment.

4. Overview of Basic Structures

A. Joint Ventures

A joint venture is created when two or more persons enter into an arrangement to invest in a project and the parties share the control, benefits, and risks of the project. The Tax Court has defined a joint venture as "a special combination of two or more persons where in some specific venture a profit is jointly sought without any actual partnership or corporate designation." See Sierra Club v. Commissioner, 103 T.C. 307, 322, aff'd in part, rev'd in part, and rem'd 86 F.3d 1526 (9th Cir. 1996).

In a partnership arrangement, the exempt hospital may serve as a general partner or as a limited partner, or as both, in a general partnership or in a limited partnership. Under IRC 7701(a)(2) the term "partnership" includes, for federal income tax purposes, a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of the Code, a trust, estate, or a corporation.

Most whole hospital joint venture arrangements have been formed as limited liability companies (LLCs). LLCs are attractive structures for joint venture transactions. An LLC member does not have personal liability for entity-level debts. However, an LLC can obtain the passthrough tax treatment of a partnership.

LLCs are formed under state law. All fifty states and the District of Columbia have adopted LLC statutes. In most states, an LLC can be formed for any lawful purpose, except for banking or insurance purposes. The powers of the LLC are recited in the articles of organization. If no limitations or restrictions are contained in the articles of organization, an LLC may possess and exercise all powers that are necessary or convenient to carry out the purposes of the LLC. In most states, an LLC must have two or more members.

Previously, the tax classification of a LLC depended on whether the organization met the Internal Revenue Code definition of "corporation" or of "partnership". The Service determined whether a LLC was taxed as a corporation or a partnership using a four factor test. An LLC that had no more than two of the corporate characteristics was treated as a partnership for federal income tax purposes.

Effective as of January 1, 1997, regulations under IRC 7701, sec. 301.7701-3, commonly referred to as the "check-the-box" regulations, apply in determining whether an LLC will be taxed as either a corporation or as a partnership. The regulations simplify the process of classifying an entity. Under the regulations, unless an entity with two or more members elects otherwise, it will be classified as a partnership by default. An LLC that seeks tax classification as a corporation must so elect. Elections to change classification can only be made once every five years. Whole hospital joint ventures operating as LLCs appear to favor the partnership classification for federal income tax purposes to achieve the passthrough capability.

Joint operating agreements (often referred to as virtual mergers) were the subject of an article in the 1997 CPE book. A joint operating agreement ("JOA") brings two or more formerly unrelated, exempt, health care organizations together to operate jointly going forward. A JOA shares the risks and rewards of operation and usually requires joint agreement as to budgets, what services will be rendered in which sites, and when and where to make capital expenditures. It achieves many of the benefits of integration without a complete merger or transfer of assets. The key difference between a JOA and a joint venture is that, in a JOA, there is no change in the ownership of assets. So far, the Service has issued rulings regarding JOAs involving only tax exempt participants. The scope of Rev. Rul. 98-15 extends only to joint ventures between nonprofit entities and for-profit corporations; not to whole hospital joint operating agreements between exempt and for-profit entities. JOAs are mentioned in this article only to describe the difference between a JOA and a joint venture.

B. Whole Hospital Joint Venture Structure

(1) Typical Configuration

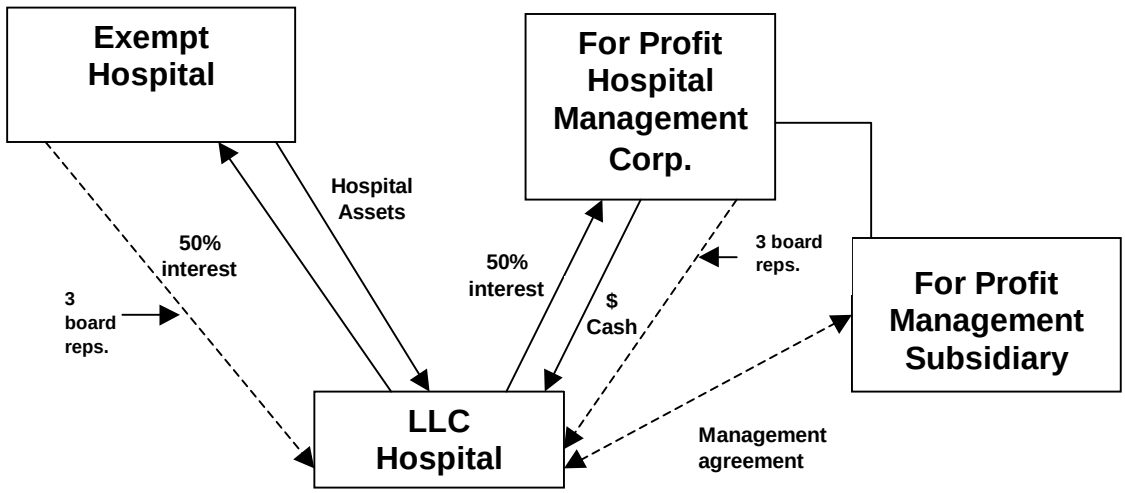
In whole hospital joint ventures, the tax exempt entity remains in existence and, although it no longer conducts hospital operations directly, it receives allocated income and distributions from its interest in the LLC.

In the whole hospital joint venture structure, also known as the "disposition-type" joint venture, the exempt hospital contributes all or substantially all of its assets to the joint venture and receives a partnership or membership interest and, in some cases, cash. The for-profit partner contributes cash, or cash and/or assets to the joint venture and receives a partnership or membership interest. The distributive share of profits and losses to each partner or member is allocated proportionately to the capital contribution amount contributed by each partner or member. The joint venture owns and operates the hospital.

To the extent that the value of the operating assets contributed by the exempt partner exceeds the value of the operating assets contributed by the for-profit partner, the for-profit will contribute cash so that its contribution is proportionate to what the parties have agreed

will be the ownership interest in the joint venture. For example, if the parties have agreed that each will have a fifty percent ownership interest in the joint venture, and the nonprofit entity contributes a hospital valued at one hundred million dollars while the for-profit entity contributes hospital assets valued at fifty million dollars, the for-profit partner will transfer fifty million dollars to the joint venture so that each organization will have acquired its fifty percent interest in return for a net contribution each of one hundred million dollars.

Typically, each ownership interest is fifty percent. Ownership interests equal the value of the assets transferred to the joint venture. Generally, each member has equal board representation. Management of the day to day operations of the hospital facility is typically in the hands of the for-profit partner or an affiliate or subsidiary of the for-profit partner. The following diagram illustrates a typical whole hospital joint venture structure:



(2) Valuation

The subject matter of valuation is controversial in the sense that there may be conflicting sources of data, questionable or unstated assumptions, different methods to estimate value, and a prospective range of values. The purpose is to obtain the data that was available to the negotiating parties when a business transaction is consummated.

A starting point in evaluating the sale, purchase or sharing of health care assets, such as a hospital, is to establish a time line, which places information concerning a transaction into perspective. This time line can serve as a basic guideline for identifying, quantifying and resolving valuation issues. Information prepared prior to the transaction date – including, for example, work papers, descriptive memos, financial analyses and meeting notes – is important for explaining and justifying a specific transaction's value or price. Information prepared at the transaction date – including, for example, competitive bids, additional sideline transactions, all signed sales contracts, employment agreements, conflict of interest policies,

and board meeting minutes – is helpful in assessing the scope of a transaction. Finally, information prepared after the transaction date – such as an appraisal of limited scope – may or may not corroborate important factors considered in arriving at a transaction price.

It is important to remember that a valuation analysis should be tailored to the specific facts of a particular transaction. Also, a valuation analysis concerns not only the contributed exempt hospital assets in a joint venture, but also the valuation of any contributed for-profit assets to the joint venture.

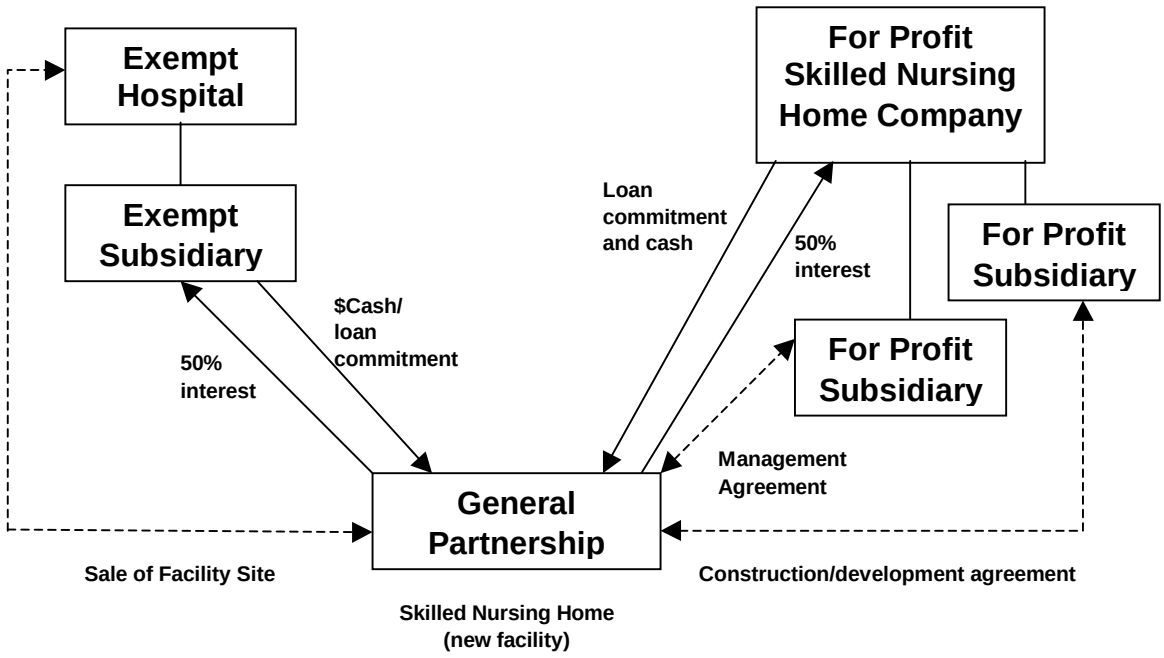
(3) Bond Financing Considerations

Tax exempt hospitals and other health care facilities are most often financed with the proceeds of qualified IRC 501(c)(3) bonds, the interest on which is excluded from a taxpayer's gross income under IRC 103. Therefore, the tax exempt status of existing bond financing should be reviewed in any joint venture between for-profit and exempt providers. In whole hospital joint ventures, the exempt partner often receives cash from the for-profit partner or from the joint venture to defease the bonds; additionally, a bond tender offer is made.

C. Hospital Subsidiary Joint Venture Structure

(1) Typical Configuration

In a hospital subsidiary joint venture transaction, an exempt hospital or hospital parent in an exempt health care system creates a wholly-owned nonprofit subsidiary that generally seeks to be recognized as exempt under IRC 501(c)(3). The subsidiary's only activity is to participate in a joint venture arrangement with a for-profit partner. The subsidiary generally contributes cash to the joint venture equal to the value of the assets transferred by the for-profit partner, or is assigned the joint venture interest of its exempt parent. The for-profit partner contributes a health care facility or service program, such as an ambulatory surgery center, MRI, physical therapy center, or home health care services. Ownership interests of each partner equal the value of the assets transferred by each partner to the partnership. The distributive share of profits and losses are allocated proportionately to the contribution amount. Typically, the exempt organization subsidiary partner and the for-profit partner share equal representation on the joint venture's governing board. The following diagram illustrates a typical hospital subsidiary joint venture:



(2) Applications

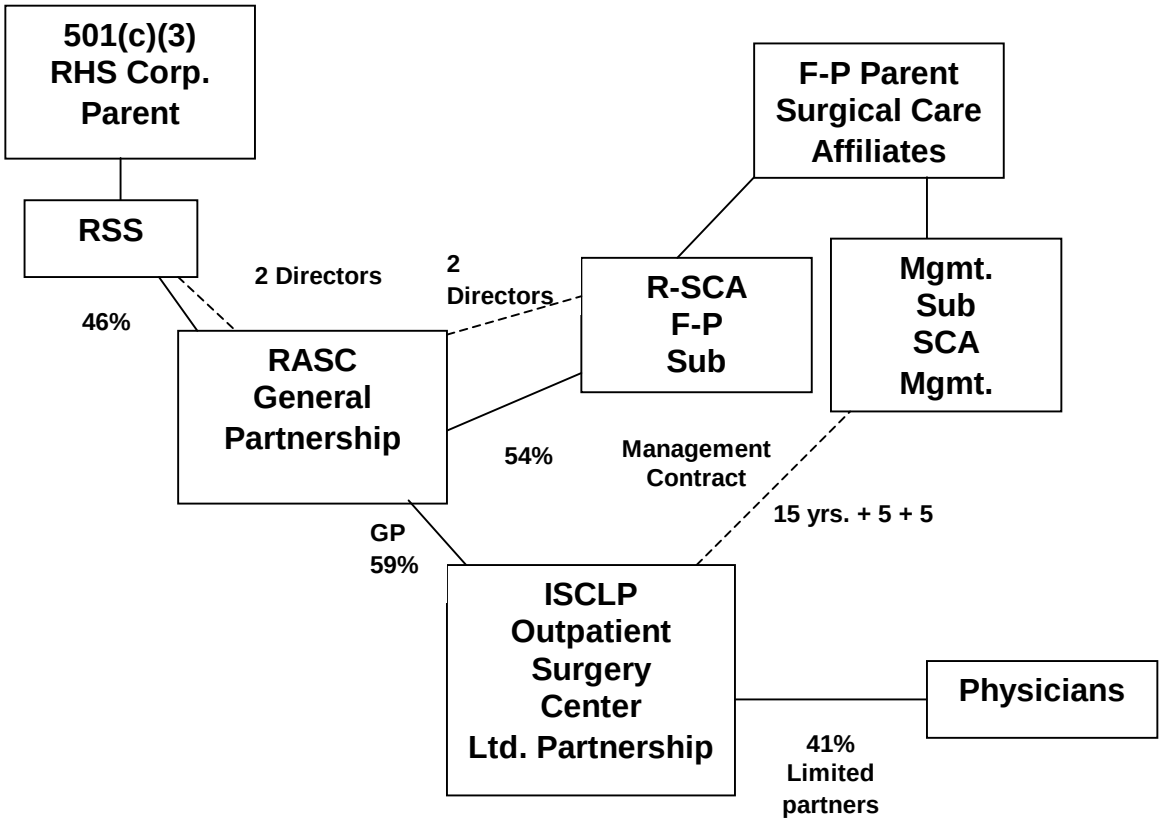
A hospital subsidiary joint venture is analogous to a whole hospital joint venture because the nonprofit subsidiary's participation in the joint venture is generally its sole activity. The nonprofit subsidiary seeks exempt status based on this sole activity. Thus, the analysis of Rev. Rul. 98-15, discussed in depth later in this article, is equally applicable to a hospital subsidiary joint venture arrangement as to a whole hospital joint venture transaction.

The Service recently has received several such applications for recognition of exemption. To qualify for exemption under IRC 501(c)(3), the organization, as any 501(c)(3) applicant, must satisfy the organizational test and the operational test under the regulations. The organizational test will be satisfied so long as the organizing documents provide that the organization is organized exclusively for exempt purposes and is not empowered to engage in activities that are beyond the scope of permissible activities under IRC 501(c)(3). It must also provide for a proper dissolution clause.

As in the whole hospital joint venture analysis, for federal tax purposes the activities of the partnership are considered to be the activities of the wholly-owned nonprofit subsidiary organization that is a partner in the partnership (or member of the LLC, if applicable), when evaluating whether the nonprofit partner is operated exclusively for exempt IRC 501(c)(3) purposes. The nonprofit organization will be operating exclusively for exempt IRC 501(c)(3) purposes if it is determined that participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the charitable organization to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of the for-profit partner or partners. See Plumstead Theatre Society, Inc. v. Commissioner, supra, and Housing Pioneers v. Commissioner, supra.

An example of a hospital system wholly owned nonprofit subsidiary established to participate in a joint venture arrangement with a for-profit partner is Redlands Surgical Services ("Redlands"). Redlands applied for exemption as an organization described under IRC 501(c)(3). The Service concluded that Redlands is not operated exclusively for exempt purposes because it operates for a substantial nonexempt purpose and its operations benefit private interests more than incidentally. The case is currently in litigation before the United States Tax Court (Docket No. 11025-97 "X").

The following diagram illustrates the Redlands joint venture structure:



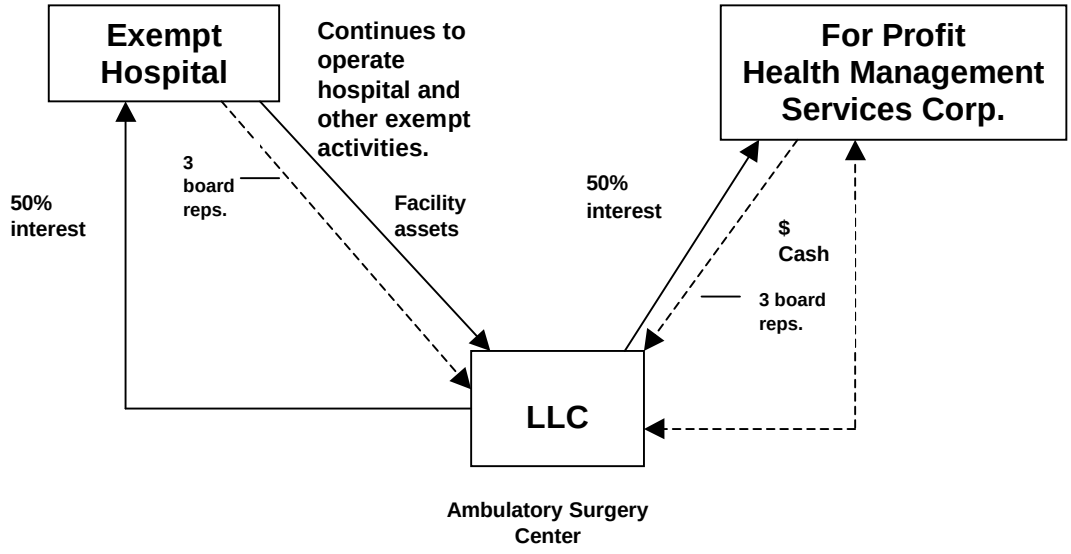
D. Hospital Ancillary Joint Venture Structure

A hospital ancillary joint venture refers to those joint venture arrangements where an exempt organization that operates a hospital or other health care facility owns an interest in a joint venture with a for-profit entity to operate a particular service. The exempt organization, usually part of a health care system, owns and operates a hospital as well as other health care facilities or services, such as an ambulatory surgery center, MRI, or home health care services. It transfers the assets of the health care facility or service to the joint venture; or contributes funds to establish the ancillary service. The for-profit partner contributes cash equal to the fair market value of the exempt organization facility transferred to the joint

venture. The joint venture owns and operates the health care facility or service. The exempt organization still owns and operates the hospital facility.

Thus, unlike the whole hospital joint venture structure, or the hospital subsidiary joint venture arrangement, the exempt organization does not contribute all of its operating assets nor is the participation by the exempt organization in the joint venture its sole activity. In the hospital ancillary joint venture, the activity conducted by the exempt organization through the joint venture arrangement is generally not the sole activity of the exempt organization, and it may not be a substantial part of the organization's activities. Instead, the exempt partner will continue to operate its hospital and other health care facilities and services.

The following diagram illustrates a typical hospital ancillary joint venture:



Hospital ancillary joint ventures are addressed in this article only for completeness. The scope of this article is limited to a discussion of whole hospital joint ventures and the application of Rev. Rul. 98-15 to such transactions, and does not attempt to analyze the hospital ancillary joint venture arrangement.

5. Published Guidelines for Whole Hospital Joint Ventures

Rev. Rul. 98-15, 1998-12 I.R.B. 6, provides guidance on the tax treatment of exempt hospitals participating in whole hospital joint ventures with for-profit entities. The guidance addresses the issue of whether a tax exempt operator of an acute care hospital may retain its tax exemption when it forms a limited liability company with a for-profit corporation and then contributes its hospital and all of its other operating assets to the LLC, which then operates the hospital.

The issues raised by an exempt organization's participation in a joint venture are whether participation in the joint venture adversely affects the organization's exempt status; whether the exempt organization retains a public charity status following its participation in the joint venture, and whether participation in the joint venture results in unrelated business taxable income to the exempt organization. The analysis of Rev. Rul. 98-15 can be applied to various health care joint venture structures, including whole hospital joint ventures and hospital subsidiary joint ventures.

A. Factual Situations

The revenue ruling presents two fact situations. In each case an exempt hospital is in need of additional funding to better serve its community. Each of the exempt organizations forms an LLC with a for-profit corporation and contributes its hospital and other operating assets to the LLC, which then operates the hospital. The LLC in each situation is treated as a partnership for federal income tax purposes. The remaining exempt entity exists only to make grants from its distributions and to participate in the joint venture.

The exempt hospital in Situation 1 retains its exempt status because it continues to operate exclusively for a charitable purpose and only incidentally for the purpose of benefiting the for-profit's private interests. In the second situation, however, the joint venture arrangement adversely affects the nonprofit hospital partner's exempt status because the nonprofit hospital cannot establish that it will operate exclusively for exempt purposes after it contributes its operating assets to the LLC.

(1) Situation 1

In the first situation, a nonprofit corporation that operates an acute care hospital contributes all of its operating assets to the LLC. The for-profit entity also contributes assets to the LLC. In return, each receive ownership interests in the LLC proportional and equal in value to their respective contributions. The LLC is governed by a board consisting of three individuals chosen by the exempt partner and two individuals chosen by the for-profit partner. A majority of three board members must approve certain major decisions relating to the operation of the LLC, including, among others listed, those concerning the acquisition or disposition of health care facilities; changes to the types of services offered by the hospital; and renewal or termination of management agreements. The LLC governing documents require that the LLC operate its hospitals in a manner that furthers charitable purposes by promoting health for a broad cross section of the community. These charitable purposes take precedence over any duty to operate for the financial benefit of the owners. These terms are enforceable under applicable state law. The governing documents may only be amended with the approval of both owners. All returns of capital and distributions of earnings are made in proportion to ownership interests in the LLC.

The LLC enters into a management agreement with a management company unrelated to either the exempt nonprofit partner or the for-profit partner. The agreement is for a term of five years, and is renewable for additional five year periods by mutual consent. The fee paid is based on gross revenues and is reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals.

None of the exempt nonprofit partner's officers, directors, or key employees involved in the negotiations was promised employment or other inducement by the LLC or the for-profit partner. None of the exempt nonprofit partner's officers, directors, or key employees have any interest in the for-profit partner or any of its related entities.

(2) Situation 2

In the second situation, an exempt nonprofit corporation that owns and operates an acute care hospital contributes all of its operating assets to the LLC. The for-profit entity also contributes assets to the LLC. In return, each receive ownership interests in the LLC proportional and equal in value to their respective contributions. The LLC is governed by a board consisting of three individuals chosen by the exempt nonprofit partner and three individuals chosen by the for-profit partner. A majority of the board members must approve certain major decisions relating to the operation of the LLC, including, annual capital and operating budgets; distributions of earnings over a required minimum level; unusually large contracts; and selection of key executives. The LLC governing documents provide that its purpose is to own and operate health care facilities and engage in other health care related activities. The governing documents may only be amended with the approval of both owners. All returns of capital and distributions of earnings are made in proportion to ownership interests in the LLC.

The LLC enters into a management agreement with a wholly owned subsidiary of the for-profit partner. The agreement is for a term of five years, and is renewable for additional five year periods at the discretion of the management company. The LLC may terminate the agreement only for cause. The fee paid is based on gross revenues and is reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals.

As part of the agreement to form the LLC, the exempt nonprofit partner agrees to approve the selection of two individuals who previously worked for the for-profit partner in hospital management to serve as the chief executive officer and chief financial officer of the LLC. Their compensation is comparable to what comparable executives are paid at similarly situated hospitals.

B. Law and Analysis

The revenue ruling states that the activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of IRC 501(c)(3), based on the aggregate principle discussed in Butler v. Commissioner, 36 T.C. 1097 (1961), acq. 1962-2 C.B. 4; and reflected in the treatment of partnerships for purposes of the unrelated business income tax under IRC 512(c).

The revenue ruling sets forth the two-part standard, based on Plumstead and Housing Pioneers that an IRC 501(c)(3) organization may form and participate in a partnership and meet the operational test, if the partnership furthers a charitable purpose and the partnership agreement permits the exempt organization to act in furtherance of its exempt purposes and only incidentally for the benefit of the for-profit partners. An exempt organization may enter into a management agreement with a private party giving that party authority to act on behalf of the organization and direct the use of the organization's assets so long as the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable. Broadway Theatre League of Lynchburg, Virginia v. U.S., 293 F. Supp. 346 (W.D.Va. 1968). United Cancer Council, Inc. v. Commissioner, 109 T.C. 326 (1997), appeal docketed, No. ____ (7th Cir. Apr. 30, 1998). The revenue ruling also states that if a private party is allowed to control or use the exempt nonprofit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized or operated exclusively for exempt purposes, citing est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), aff'd in unpublished opinion 647 F.2d 170 (9th Cir. 1981); and Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974).

C. Application to the Factual Situations

The determination as to whether a joint venture furthers the charitable purposes of the exempt nonprofit partner; and whether the arrangement permits the exempt partner to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of the for-profit partner, is based on all of the facts and circumstances. The revenue ruling considers whether or not the exempt partner has been able to maintain sufficient control over its activities for it to be able to establish that it will be operated exclusively for exempt purposes. This is not a narrow look at control. For instance, more than ownership percentages and board votes are taken into consideration, including, powers and restrictions reflected in the organizational documents. Facts and circumstances for a particular case other than those listed in the revenue ruling may be relevant. Based on facts and circumstances, the revenue ruling is intended to provide guidance as to whether a joint venture is generally problematic.

(1) Situation 1

In *Situation 1*, the exempt partner's activities consist of the health care services it provides through the LLC and any grant making activities it conducts using the income distributed by the LLC. The exempt partner will receive an interest in the LLC equal in value to the assets it contributes, and its returns from the LLC will be proportional to its investments in the LLC. The LLC's governing documents, enforceable under state law, commit the LLC to provide health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits. The exempt partner appoints members of the community familiar with the hospital to the LLC board, the board's structure allows the exempt partner voting control, and the board is afforded specifically enumerated powers over changes in activities, including disposition of assets, changes to services provided, and renewal of the management agreement. The management company is unrelated to either the nonprofit or the for-profit partner, and the terms and conditions of the management agreement are reasonable. Based on all these facts and circumstances, the revenue ruling concludes that when the exempt partner participates in forming the LLC and contributes all of its operating assets to the LLC, and the LLC operates in accordance with its governing documents, the exempt organization is furthering charitable purposes and continues to be operated exclusively for exempt purposes, with any benefit to private parties only incidental to the accomplishment of exempt purposes.

(2) Situation 2

In *Situation 2*, the exempt partner's activities consist of the health care services it provides through the LLC and any grant making activities it conducts using income distributed by the LLC. As a business enterprise, the LLC will not necessarily give priority to the health needs of the community over profits. The LLC governing documents also lack a binding obligation to serve charitable purposes. Moreover, the structure of the board, where the nonprofit partner and for-profit partner share control, does not allow the tax exempt to ensure that new health care needs of the community are met without the agreement of at least one governing board member appointed by the for-profit partner. The primary source of information for board members appointed by the exempt partner will be the chief executives, who have a close relationship with the for-profit partner and the management company, which is a subsidiary of the for-profit partner. The management company has broad discretion over the activities and assets of the LLC that are not always under the board's supervision, and it may unilaterally renew the management agreement. Thus, unlike Situation 1, the facts and circumstances lead to a conclusion that the LLC will not be engaging primarily in activities that further an exempt purpose and the benefit to the for-profit partner resulting from the activities conducted by the exempt partner through the LLC will not be incidental to the furtherance of an exempt purpose. Thus, in these circumstances, the exempt organization fails the operational test when it forms the LLC, contributes its operating assets to it, and then serves as members of the LLC.

D. Foundation Classification

Prior to the formation of the LLC and the transfer of all of its operating assets to the LLC, the exempt organization discussed in Situation 1 was classified as other than a private foundation by virtue of being described in IRC 509(a)(1) and 170(b)(1)(A)(iii). IRC 170(b)(1)(A)(iii) describes an organization that is a hospital that has as its principal purpose or function the provision of medical or hospital care or medical education or research.

After contributing all of its operating assets to the LLC, the tax exempt organization will have at least two potential sources of revenue. One will be its allocable distribution of earnings from the LLC. The other will be the earnings from the investment of any funds received from the establishment of the LLC. In addition, by participating in the creation of the LLC and contributing all of its operating assets to the LLC, the exempt organization's activities will consist of the health care services it provides through the LLC and the grant making activities it conducts using income distributed by the LLC.

Because the exempt partner's grant making activity will be contingent upon receiving distributions from the LLC, the exempt organization's principal activity will continue to be the provision of hospital care. As long the exempt organization's principal activity remains the provision of hospital care, it will not be classified as a private foundation in accordance with IRC 509(a)(1) as an organization described in IRC 170(b)(1)(A)(iii).

6. Development of Examination Cases and Exemption Applications Involving Joint Ventures

To reiterate, the activities of the joint venture are considered to be the activities of the exempt organization that is participating as an owner or general partner of the joint venture. Therefore, when evaluating whether an organization that either is under examination or that has applied for exempt status is operated exclusively for exempt purposes within the meaning of IRC 501(c)(3), look to the activities of the joint venture. If participation in the joint venture furthers an exempt purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purposes and only incidentally for the benefit of the for-profit partners, the organization will be considered to be operated exclusively for exempt purposes.

Such a determination, by its very nature, is based on the facts and circumstances. Therefore, development of the facts of an examination or application case is essential. The pertinent documents that must be scrutinized include, but are not limited to the partnership agreement or LLC operating agreement; the LLC articles of incorporation or partnership organizing document; the LLC or partnership contribution agreement; the appraisal report; the management contract; employment agreements; and minutes of board meetings for the exempt organization; and minutes of the LLC board meetings.

The following inquiries may be useful in discerning whether the partnership furthers charitable purposes and whether private benefit to the for-profit partners and/or manager is greater than incidental:

1. Does participation in the joint venture by the exempt organization further its exempt purposes?

   For example, is it necessary for the nonprofit to participate in the joint venture because of its needs for capital, expertise, or assets? Merely increasing a competitive edge through, for example, potential referrals from participating physicians does not further exempt purposes; nor does selling the net revenue stream. See GCM 39862.

2. Is the partnership required by its governing documents to promote the health of a broad section of the community?

3. Do the joint venture agreements explicitly state that the governing board members have a duty to promote the health of a broad cross section of the community which takes precedence over any other fiduciary duty, such as maximizing profits?

4. Is there actual evidence that partnership activities are undertaken chiefly to promote the health of a broad cross section of the community rather than to produce profits?

   For example, what is the Medicare and Medicaid payer mix and the indigent care mix; what is the extent of community service programs, teaching, or research conducted; is there an open emergency room; open medical staff; admission of patients able to pay directly or through third party payers; what do minutes of board meetings reflect in terms of how decisions are reached affecting the level of community care; does the exempt organization have the authority to compel compliance with community benefit standards, and if so, how has it exercised this authority.

5. How is the governing board of the joint venture selected?

6. Who is on the governing board of the partnership?

7. What is the governing structure for the joint venture board?

   For example, are major decisions approved by a majority vote of the governing board; are they approved through block voting; how are deadlocks decided; what are the quorum requirements.

8. What decisions are approved by the board?

In other words, who has the right to change the partnership's governing documents; approve the partnership's annual capital and/or operating budgets; approve partnership distribution of earnings and of available cash; approve additional capital contribution calls; approve partnership assumption of additional indebtedness; approve partnership acquisition or disposition of health care facilities; approve unusually large contracts, including managed care, provider, equipment, pharmaceuticals, and other goods and service contracts; approve changes in the types of services offered at the health care facilities; select key executives of the partnership and of the health care facilities; ensure adequate reserves; credentialize professional staff; hire and fire employees; and, compel an audit.

9. If there is a management firm, how is it selected?

   For example, is it a firm that is affiliated to the for-profit partner? Do the terms of the joint venture agreement require the use of a firm related to the for-profit partner?

10. How is the management firm paid?

    For example, is the fee reasonable in terms of comparables for similarly situated management firms? Does the fee represent an improper sharing of net revenues?

11. What are the other terms of the management agreement, including length of contract, renewals, and termination rights?

12. What are the duties of the management firm?

    This should be viewed in terms of whether there are any duties that may conflict with the partnership's ability to promote the health of a broad section of its community. Another concern would be if the management firm's powers restrict the authority of the exempt organization's representatives to the board of directors to initiate or react to decisions that would ensure community benefit.

13. How are fees and prices for the delivery of health care determined?

14. How are key executives selected and approved?

15. Who establishes compensation for physicians and for executives?

16. How are accountants and attorneys for the partnership selected? How are accountants and attorneys for the exempt hospital selected? Do such accountants and attorneys also represent the for-profit partner?

17. Are returns of capital and distributions of earnings of the partnership required to be proportional to capital contributions?

18. How are issues brought to the governing board?

19. Were any of the exempt organization's executives or governing board members promised positions within the LLC or with the for-profit partner or affiliates of it, or offered other personal financial inducements to approve the affiliation?

20. Do any of the representatives of the exempt partner who serve on the governing board of the partnership have a conflict of interest with their ability to represent community interests?

    For example, are they financially interested through employment arrangements or otherwise dependent on the hospital or partnership for their livelihood?

21. Who is responsible for establishing and setting medical and ethical standards?

22. Who has oversight of the quality of health care?

    Ensure that if oversight is within the control of the exempt organization, it is meaningful.

23. What specific activities does the exempt organization conduct?

24. What are the specific responsibilities of the exempt organization with respect to the partnership?

These factors are not exhaustive. Depending on the situation, additional or different factors may need to be developed and considered in determining whether the partnership arrangement allows the nonprofit organization to operate exclusively for charitable purposes.

7. Summary

As the health care industry continues to evolve at record speed, it is difficult, if not impossible, for the Service to stay ahead of new developments in the area. The Service has now released Rev. Rul. 98-15 to help resolve tax questions regarding joint ventures between nonprofit tax exempt organizations and taxable, for-profit corporations. The revenue ruling

also may be useful in examining joint ventures with for-profit partners entered into by exempt organizations other than health care organizations.

Rev. Rul. 98-15 does not seek to curb all joint ventures between for-profit and tax exempt hospitals. It allows tax exempt hospitals the flexibility to partner with another organization or corporation. However, it does require that charitable purposes supersede profit maximization purposes. It dictates that health care services benefit the community as a whole. It obliges exempt organizations that enter into such partnerships to ensure that the partnership furthers charitable purposes; and does not result in greater than incidental private benefit to the taxable partner nor to other private parties. Thus, while the factual scenarios discussed in the revenue ruling represent newly evolved developments, the reasoning of the revenue ruling is not a departure from existing law.